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How the Accounting Profession is Adapting to Prevent Another "Enron"

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Executive Summary

• **The Auditing Standards Board issued new auditing standards**. The new standards modify and expand standards addressing internal controls, audit documentation, and consideration of fraud.

• **The American Institute of Certified Public Accountants** and the Securities Exchange Commission are working together to gain back investor confidence. They agreed on prohibitions preventing audit firms from providing consulting services for their public audit clients. They are also implementing a new oversight board to oversee CPA firms performing audits.

• **The American Institute of Certified Public Accountants** enhanced audit documentation and fraud consideration requirements. Statement on Auditing Standard No. 96 now requires auditors to provide more documentation to support their findings. Statement on Auditing Standard No. 99 now requires auditors to be aware of fraud outside of internal controls.

• **Enron taught the accounting profession many valuable lessons**. These lessons include the importance of Generally Accepted Auditing Standards, maintaining independence, and acting with professional ethics.

The accounting profession has had a successful 100-year history of self-regulation. Since the collapse of Enron, the accounting profession has received criticism of its self-regulation system. Therefore, the American Institute of Certified Public Accountants (AICPA) is diligently working to improve the profession. The AICPA has implemented many changes to help the profession regain investor confidence and the trust of the public. The Auditing Standards Board (ASB) is working on new auditing standards. Furthermore, the AICPA is working with the Securities and Exchange Commission

(SEC) to improve the effectiveness of the audit. There have already been many changes and more are expected in the future for the accounting profession.

Some of the major changes are in the form of new auditing standards. In late 2001 or early 2002, the ASB issued new standards and exposure drafts that modify some of their earlier standards. These new standards follow an ASB investigation of current audit procedures. Some of the more important changes to the standards include a clarification of how auditors may obtain evidence concerning the effectiveness of internal controls, clarification of how auditors plan and perform an audit with different levels of control risk, an increased emphasis on the importance of controls and what constitutes sufficient knowledge of controls to plan the audit. There have been six new auditing standards issued since Enron filed for bankruptcy.

One of the first standards issued after Enron was Statement on Auditing Standards (SAS) No. 94, *Consideration of Internal Control in a Financial Statement Audit.* This statement modifies SAS No. 55. The new standard provides guidance about the effect of information technology on internal controls and how the auditor understands internal controls and control risk. It helps to determine if special skills are going to be required to thoroughly understand the affects of the computer on internal controls and to design appropriate audit procedures. Therefore, it deals with how information systems can affect internal controls and how the auditor must deal with the information system to adequately understand internal controls and assess control risk.

Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards* deals with the AICPA's Professional Code of Conduct which states that the auditor will comply with the ten Generally Accepted Auditing Standards (GAAS) when conducting an audit. SAS No. 95 requires the auditor to use professional judgment in applying the ten auditing standards. Along with professional judgment, materiality and audit risk are also important in the application of the standards dealing with field work and reporting. Furthermore, auditors must justify any departures from Auditing Standards. This standard basically defines how the auditor is to conduct the audit according to GAAS.

Statement on *Auditing Standards* No. 96, Audit Documentation, is the first significant change in the requirements auditors must follow when documenting their audit work. This standard modifies SAS No. 41, *Working Papers*, which serves mainly to help the auditor conduct and supervise the audit. SAS No. 96, requires the auditor to consider risk of material misstatement associated with management's assertions, the extent of judgment exercised by the auditor, the nature of the auditing procedures, significance of evidence obtained to assertion being tested, nature and extent of exceptions the auditor identifies, and the need to document conclusions not evident from the work the auditor performed. This standard also deals with the sufficiency of documentation to enable the audit team or supervisors to understand the evidence the auditor discovered, and the requirements dealing with how long documentation should be maintained. Other SASs modified by SAS No. 96 includes SAS No 47, *Audit Risk and Materiality in Conducting an Audit*; SAS No. 56, Analytical Procedures; and SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Growing Concern.*

The ASB recently issued SAS No. 99, *Consideration of Fraud in a Financial Statement*, which goes into effect for audits beginning on or after December 15, 2002. This standard amends SAS No. 1, *Codification of Auditing Standards and Procedures* and SAS No. 85, *Management Representations.* Some of the context of SAS No. 99 includes the description and characteristics of fraud, the importance of exercising professional skepticism, obtaining the information needed to identify risks of material misstatements due to fraud, identifying risks that may result in a material misstatement due to fraud, and responding to the results of the assessment. This standard will affect the way an audit is performed. Auditors will have to be alert to the possibility of fraud during the planning phase and throughout the audit. If they suspect fraud, they must respond by changing the way the overall audit is performed. This may include changing the extent, nature, or timing of audit procedures performed. It will also require adding procedures addressing management's override of controls.

Other standards issued by the Auditing Standards Board include: SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles*; and SAS No. 98, *Omnibus Statement on Auditing Standards-2002*. SAS No. 97 deals with prohibiting the auditor from providing written reports dealing with the application of accounting principles not involving facts or circumstances of a specific entity. However, Statement on Auditing Standards No. 98, the Omnibus Statement on Auditing Standards-2002 modifies many of the existing statements including SAS No. 95

Besides the new auditing standards, the AICPA has implemented an auditor's tool kit to help auditors identify and deal with related party transactions. The auditor's tool kit adds nothing new; however, it consolidates all existing reporting and audit guidance covering related party transactions. Auditors now have, in one place, an overview of the auditing and accounting literature, checklists, and other tools to gather evidence and disclose related party transactions. The tool kit lets auditors know what the SEC requirements are and the best way to deal with related party transactions.

Along with the changes already made by the profession, the AICPA has announced their agreement with the SEC on several other areas for improvement. They agreed to prohibitions that would prevent audit firms from performing consulting services or internal audit services for their public audit clients. CPA firms will no longer be permitted to help in system designs or other consulting services if they want to perform the client's audit. The AICPA does not think that this separation of audit and consulting services will improve the effectiveness of the audit; however, they agreed with the separation to help gain back investors' confidence.

Along with the prohibitions concerning consulting services provided for audit clients, the AICPA will cooperate with the SEC to implement a new oversight board. The board will primarily be made up of members outside the profession. This board will investigate alleged audit failures and perform peer reviews of the largest CPA firms. In addition, they will have disciplinary responsibilities over firms performing audits of public companies. The new peer review will require a more rigorous and continuous form of monitoring. The new board will administer the peer reviews since the Public Oversight Board terminated their existence March 2002. No one is quite sure how the new peer reviews and disciplinary actions will be implemented.

The AICPA has taken a strong stand on audit documentation and fraud consideration since Enron. SAS 96 will affect the auditing profession concerning the nature and extent of documentation, sufficiency of audit documentation, documentation of significant findings or issues, and the retention of audit documentation. Concerning the nature and extent of documentation, auditors are now going to be required to include abstracts or copies of significant contracts or agreements that are examined. They must perform tests of operating effectiveness of controls and substantive tests of details that involve document examination and identification of six factors that auditors should consider in determining the nature and extent of documentation. SAS No. 41 provided no guidance other than some factors concerning the engagement level that affects auditor's judgment regarding quantity, type and content of working papers. Moreover, auditors should document items they believe to be significant and any actions taken to address them. There is no similar requirement under SAS No. 41. Auditors will now provide more documentation to support their findings. They are responsible for maintaining and safeguarding that documentation. More documentation will help ensure that auditors are performing the necessary steps to support their findings. If auditors had provided adequate documentation to support their findings, problems at Enron may have been detected before serious problems developed. Another auditor might have noticed something in the documentation that may have led to an investigation earlier.

SAS No. 99 changes the way audits are performed since they now require auditors to be aware of fraud when performing the audit. In the past, auditors were not responsible for fraud that occurred outside of internal controls. Now they must consider whether fraud has taken place and act accordingly to ensure that they obtain information needed to identify any possible misstatements due to fraud. Consequently, auditors must examine journal entries and adjustments for evidence of possible material misstatement due to fraud, review accounting estimates that could result in misstatements, and evaluate the business rationale for significant unusual transactions. Auditors are required to evaluate audit evidence throughout the audit to assess the risks of material misstatements due to fraud during the final review of the audit. They are required to evaluate identified misstatements for the possibility of fraud. If they discover fraud, they are to document and report their findings to the audit committee or management. This standard requires auditors to take an in-depth look at the financial statements and determine the fairness of management's assertions and evaluate any misstatements because of possible fraud by management.

Since the collapse of Enron, the accounting profession has had to deal with many issues. Investors lost faith in the stock market and want to know why the problems leading to Enron filing for bankruptcy were not disclosed. The profession has to discover why Enron went bankrupt and what actions to take to ensure it does not happen again. Auditors learned many lessons from the collapse of Enron. These lessons include the importance of the ten auditing standards, independence, audit fees, ethical behavior, and fraud and related party transactions.

The success of the audit depends on the auditor following GAAS; these standards exist for a reason. GAAS must be followed to ensure that a fair audit is conducted. However, the auditing standards do not guarantee that material mistakes are identified. They do reduce the chance that they will go undetected. One of the ten generally accepted auditing standards deals with independence. This is an important issue that must be followed to ensure a fair audit. Auditors must be independent in fact and in appearance. It is important that the auditor appears independent to the investors. If not, they will loss the confidence of the investors. Even if they are in fact independent, they will have lost investor confidence.

One way the auditor can maintain their independence in fact and appearance is by setting the price of the audit based on the resources involved and the level of risk associated with the audit. It is important to set the audit fee in the engagement letter. This audit contract states what is expected from the client and what services the auditor agrees to perform. It is important that these aspects of the agreement be clarified and agreed to by both parties before audit work begins with no contingent fees involved to impair independence. Also, the audit contract should allow for adjustment of the audit fee due to the increase in audit risk.

The importance of strict adherence of professional ethics was another lesson the profession learned from the bankruptcy of Enron. Many of the problems associated with Enron were due to the unethical behavior of the auditors. If the auditors had acted ethically, and used due care, they may have identified the problems and required Enron to make adjustment before the Statements were issued. Unfortunately, investors based their opinions on misleading statements, Enron filed for bankruptcy, and many investors lost their savings.

Auditors have to be aware of the possibility that fraud has occurred. It is important to accurately assess audit risk and perform sufficient tests to satisfy the auditor that fraud has not occurred. In the past, auditors were not responsible for detecting fraud outside of internal controls. Now, auditor's responsibility has been expanded. Management's assertions must be corroborated by performing tests to satisfy the auditor to the truthfulness of those assertions. Along with fraud, auditors must be aware of related party transactions and determine if they are recorded and reported appropriately. If the substance of Enron's liability transactions with related party subsidiaries had been recorded and reported, fair statements with full disclosure would have allowed investors to make informed decisions about Enron.

The auditing profession has implemented many changes that affect the way auditors do their jobs. Auditors must remain independent and follow GAAS. There must be no appearance that the auditor is not independent if they want to gain back investor confidence. To help ensure the auditor appears independent, the audit fee should be stated in the engagement letter when the audit is accepted. The most important thing the auditor can do to regain investor confidence and help the profession is to be ethical. Auditors must use professional judgment to determine if sufficient evidence exists to satisfy the auditor. Auditors must exercise due care in determining if fraud has occurred. They can no longer ignore management's override of internal controls. The auditor must evaluate every material misstatement for possible fraud. Auditors must document their findings in a way that other members of the team and supervisors can understand what tests were conducted. They are also required to maintain documentation for as long as it meets the needs of their practice and to satisfy any legal and regulatory requirements. Numerous changes have been made to the auditing field to improve the quality of an audit and to regain investors' confidence.

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